STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

ILLINOIS–AMERICAN WATER COMPANY	**:**	
	:	
	:	**00–0340**
Proposed general increase in water rates	**:**	
	:	

REPLY BRIEF OF ILLINOIS–AMERICAN WATER COMPANY

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REPLY BRIEF OF ILLINOIS–AMERICAN WATER COMPANY

Illinois–American Water Company ("Company"), by Chapman and Cutler, its attorneys, hereby presents its reply brief in support of its requested rate relief. This brief separately replies to the respective initial briefs of the Commission Staff ("Staff"), Illinois Industrial Water Customers ("IIWC") and City of O'Fallon, *et al*. ("O'Fallon").

I.

SUMMARY OF COMPANY'S POSITION

There are only three issues remaining to be resolved: rate of return on common equity, depreciation rate for services, and rate design.

A. Rate Of Return On Common Equity

The Company has requested a rate of return on equity of 11.25%. Its expert witness Paul Moul supports a higher rate. However, the Company proposes 11.25% to mitigate rate impacts on its customers.

Witnesses for Staff and IIWC have attacked portions of Mr. Moul's testimony. However, Staff and IIWC have failed to recognize that **their** testimony is seriously flawed. When Staff

and IIWC calculations are corrected, both Staff and IIWC support 11.25% or higher as the Company's cost of common equity.

Two examples of the required corrections will illustrate this fact:

1. Staff

In the very recent rate case *Consumers Illinois Water Company*, Docket No. 99–0238, Staff eliminated from its comparable public utility sample used to calculate its DCF value the companies whose DCF values were below the yield on A–rated public utility bonds. It also eliminated its entire water company sample because several of the companies had DCF values below the bond yield. The Commission, in its March, 2000 order in the *Consumers Illinois* case, approved Staff's adjusted DCF calculation.

In the instant case, three companies which appear in both of Staff's samples have yields below the current yield on A–rated public utility bonds of 8.13%. They are:

Connecticut Water Service	6.96%
Pennichuck Corp.	7.22%
Middlesex Water	7.69%

Clearly, consistency and fairness require that the Company's cost of common equity be calculated in accordance with the policy applied by Staff and approved by the Commission in the *Consumers Illinois* case.

If the only correction to Staff's calculation were to adjust the comparable sample and eliminate the water sample as was done in the *Consumers Illinois* case, Staff's cost of common equity calculation would be 11.1%. By itself, this one correction will result in an increase in Staff's recommendation to approximately the Company's request of 11.25%.

2. IIWC

The most obvious flaw in the testimony of IIWC witness Gorman is his inclusion of acquisition target E–Town Corporation in his samples. Both Mr. Moul and Staff witness McNally demonstrated that E–Town must be deleted because it inappropriately distorts the calculation. In fact, E–Town was acquired November 29, 2000. E-Town no longer exists as an independent company with traded stock, a fact of which the Commission should take administrative notice.

If the only correction made to Mr. Gorman's calculation was to remove E–Town from his samples, his cost of common equity would increase to 10.7%.

B. Depreciation Rate On Services

The Company has proposed a depreciation rate for services of 6.49% based upon a conservative net salvage value of (-300%). It presented uncontroverted evidence that the actual salvage value is (-400% to –450%), meaning that even a higher depreciation rate could be justified.

In its testimony, Staff has proposed a depreciation rate for services of 3.85% based upon an arbitrarily assumed salvage value of (-150%). Staff witness King did not dispute the Company's data. He presented no evidence to support his position. The Company answered all of his concerns.

The Commission should approve the Company's proposed depreciation rate for services, and make the resulting adjustments to depreciation expense, accumulated depreciation and deferred income taxes. Staff's initial brief did not discuss this issue and presumably has conceded the Company's position.

C. Rate Design

The Company has proposed an across–the–board rate increase, so as to mitigate impacts on large volume customers who may have the potential to leave its system or to reduce demand. IIWC supports the Company's position, as to the single–tariff pricing group.

Staff's proposal to allocate the rate increase based on a cost of service study would unfairly impact large volume customers.

As another mitigation effort, the Company has proposed the Alton Source of Supply Charge, applicable only to the Alton District. This charge will reduce the rate impact of the new Alton treatment facility on Districts within the single–tariff pricing group outside of Alton.

IIWC opposes the proposed charge, although it would benefit from it and will pay higher rates if it is not approved. O'Fallon supports the charge.

II.

REPLY TO STAFF INITIAL BRIEF

A. Introduction

Staff's initial brief discusses only the issues of cost of common equity and rate design. Accordingly, Staff apparently has conceded the issue as to the proper depreciation rate for services.

B. The Commission Should Approve The Company's Requested Rate Of Return On Common Equity

1. Introduction

The Company has requested a rate of return on common equity of 11.25%. The Company presented expert witness Paul R. Moul, who developed cost of equity values **higher**

than the Company's recommendation. The Company requested a lower number to mitigate the rate impacts of this proceeding (Company initial brief, pp. 2–3).

Staff's initial brief forgets this fact. Instead, Staff criticizes Mr. Moul's methodologies with no real purpose (Staff's initial brief, pp. 24–29).

Staff's initial brief incorrectly asserts Staff's cost of common equity ranges from 8.27% to 8.54%, with a midpoint of 8.4% (p. 9). Staff's proposed cost of common equity is 9.9% to 10.5% with a midpoint of 10.2% (Staff Exhibit 3.0).

Staff also forgets that, if Staff's cost of common equity calculation is corrected, Staff's recommendation is equal to or even greater than the 11.25% requested by the Company.

Staff arbitrarily assumes that its methodology is perfect and that anyone who disagrees with it must be wrong. However, even Staff admits that there is measurement error involved in many of its estimates (T. 321). It is such error in Staff's positions, precisely, which must be corrected.

2. Staff's Proposed Cost Of Common Equity Is Seriously Flawed And Significantly Understates The Company's Cost Of Common Equity

Staff witness Michael McNally has proposed a midpoint return on common equity of 10.2%, using his version of DCF and CAPM methodologies for both a water utility sample and a public utility sample. Staff's calculation of the Company's cost of common equity is seriously flawed in several material ways, causing an unreasonably low midpoint value for its cost of common equity calculation (Company initial brief, pp. 3–15).

a. Staff's DCF Calculation Is Flawed Because It Includes Unreasonably Low Values

According to Mr. McNally, the yield on A–rated public utility bonds is 8.13% (Staff Exhibit 3.0, p. 24). Nevertheless, Mr. McNally included in both his samples three companies with DCF values significantly below 8.13%. They are:

Connecticut Water Service	6.96%
Pennichuck Corp.	7.22%
Middlesex Water	7.69%

Moreover, Mr. McNally's DCF value for Connecticut Water Service is **below** Illinois–American's embedded cost of debt of 6.97%.

Mr. Moul, in his rebuttal testimony, pointed out that these companies should be eliminated from Staff's calculation because their DCF costs of common equity are below the yield on A–rated public utility bonds. Mr. Moul stated that "the cost of equity cannot be lower than the cost of debt because the higher risk of equity mandates that its cost must exceed the cost of debt by a meaningful margin." (Company Exhibit R–7, p. 7.) **Mr. McNally agreed with this quote** (T. 319).

In *Consumers Illinois Water Company*, Docket No. 99–0238, Staff expressly eliminated E–Town Corp. from its comparable public utility sample because its DCF value of 7.48% was below the then yield of 7.85% on A–rated public utility bonds (Company Exhibit SR–2, p. 2). Furthermore, in the *Consumers Illinois* case, Staff **disregarded** its entire water utility sample because many of the companies in the sample had DCF values below the yield on A–rated public utility bonds; including Connecticut Water Service (*Id*.).

The **sole reason** stated by Staff in the *Consumers Illinois* case for its adjustments is as follows:

> "Nevertheless, a comparison of the individual company DCF estimates to the current 7.85% yield on long–term A–rated utility bonds suggests that some of those estimates are probably too low. Therefore, I eliminated the DCF estimates for E–Town Corporation from the comparable sample because the estimated rate of return was less than the bond yield. In addition, I did not include the DCF results for the water utility sample because the estimated rates of return for most of the companies in the sample were below the 7.85% yield on long–term A–rated utility bonds." (*Consumers Illinois* case, Staff Ex. 3.0, pp. 24–25.)

Mr. Moul pointed out that the differences between the DCF values of the companies deleted in the *Consumers Illinois* case and the then yield on A–rated public utility bonds are **less** than the shortfalls of similar companies in the instant case (Company Exhibit SR–2, p. 3):

	Consumers Illinois		Illinois–American	
	DCF	Shortfall*	DCF	Shortfall**
E–Town	7.48%	0.37%		
American States	7.13%	0.72%		
Connecticut Water Service	7.15%	0.70%	6.96%	1.17%
Pennichuck			7.22%	0.91%
Middlesex Water			7.69%	0.44%
Average Shortfall		0.60%		0.84%

*Difference between 7.85% and DCF; **Difference between 8.13% and DCF.

In other words, the rationale applied by Staff and the Commission in the *Consumers Illinois* case to eliminate unreasonably low DCF values is even **more applicable** in the instant

case. It must be remembered that the **sole reason** stated by Staff for its adjustments in *Consumers Illinois* is that the deleted companies had DCF values below the yield of A–rated public utility bonds.

Since the Commission in its March, 2000 order in the *Consumers Illinois* case approved Staff's cost of capital recommendation, it approved and confirmed as a policy these Staff adjustments to its DCF calculation.

Consistency and fair treatment should have compelled Staff to delete from its DCF calculation for Illinois–American the companies whose DCF values are below the current 8.13% yield on A–rated public utility bonds. In fact, on cross–examination, Mr. McNally acknowledged that his procedure was to follow past Staff practice (T. 296). Consistency, fair treatment, and equal protection now should cause the Commission to make these adjustments in its order.

If Staff's DCF calculation is corrected to eliminate from its samples the three companies whose DCF values are below 8.13%, Staff's recommended cost of common equity would become **11.0%**. Staff's DCF calculation would change as follows:

	Original Staff DCF	Revised Staff DCF
Water Company Sample	9.16%-9.93%	10.56%-11.90%
Comparable Sample	9.88%-10.58%	11.17%-12.23%
DCF Average	9.9%	11.5%

Staff's cost of common equity calculation would change as follows:

	Original Staff	Revised Staff
Range	9.9%-10.5%	10.5%-11.5%
Midpoint	10.2%	11.0%

(*See* Company Exhibit SR–2, p. 4.)

However, in the *Consumers Illinois* case, Staff and the Commission also eliminated the entire water utility sample because many of the companies had DCF values below the A–rated public utility bond yield. In *Consumers Illinois*, 42% of the total DCF values were below the bond yield. In the instant case, 43% of the DCF values are below the bond yield. In other words, the rationale for disregarding the entire water utility sample equally applies to the instant case.

If Staff's comparable sample were adjusted and the water utility sample eliminated, as was done in *Consumers Illinois* earlier this year, Staff's cost of common equity would become **11.1%**. The DCF calculation would become:

	Original Staff DCF	Revised Staff DCF
Comparable Sample	9.88%-10.58%	11.17%-12.23%
Midpoint	9.9%	11.7%

The corrected cost of common equity would become:

	Original Staff	Revised Staff
Range	9.9%-10.5%	10.5%-11.7%
Midpoint	10.2%	11.1%

Staff's cost of common equity calculation, corrected solely to be consistent with the Commission's order in the *Consumers Illinois* case, at 11.1% would become essentially identical to the 11.25% requested by the Company.

In its initial brief, Staff attempts to testify with assertions why the Commission should not follow the policy set forth in *Consumers Illinois* (pp. 13–18). Apart from being inappropriate, Staff's assertions are plain wrong.

1. Staff asserts that some DCF values are high, some are low, some may be erroneously high, some may be erroneously low (pp. 13–14). There is no

evidence that higher DCF values are unreasonable, unlike the low DCF values below the yield on A–rated public utility bonds. Investors expect high returns for high growth companies. However, that was not the rationale of Staff's adjustment in *Consumers Illinois*. The deletions were made solely because the DCF values were unreasonably low.

2. Staff asserts that the distribution in *Consumers Illinois* was "skewed downward" and that the same is not true in the instant case. Staff then recites percentage numbers purporting to show the effect on range spreads of deletions. These numbers are not in the record of either case. Moreover, such "spreads" were not given as a reason for the Staff's action in *Consumers Illinois*. Again, the **sole** reason stated by Staff was to eliminate DCF values below the yield on A–rated public utility bonds.

3. Staff asserts that removal of the unreasonably low DCF values would reduce the range of estimates (Staff initial brief, p. 14). It should! Moreover, in *Consumers Illinois,* Staff expanded the range by 40 basis points on both ends of its range.

4. Staff also asserts that in the instant case it is acceptable to retain unreasonably low DCF values. This is nonsense. In *Consumers Illinois* companies were not deleted because there were no high values. They were deleted because they were below the yield on A–rated public utility bonds. Moreover, the higher numbers in the instant case were derived using Staff's methodology which it claims is correct.

Another irrelevant assertion by Staff is that the average equity risk premium for the water sample was only 51 basis points in *Consumers Illinois,* whereas it is 176 basis points in the instant case. Again, Staff relies on data not in the record.

Regardless, if Staff wants to play with numbers, then it should consider this:

		Basis Points
1.	Average Equity DCF risk premium recommended by Staff in *Consumers Illinois* (10.29-7.85)	244
2.	Average Equity DCF risk premium recommended by Staff in instant case (9.9-8.13)	177

In other words, in *Consumers Illinois*, Staff recommended a DCF equity risk premium almost 40% greater than it has recommended herein, even though interest rates were lower in the *Consumers Illinois* case (7.85% v. 8.13%). Moreover, in *Consumers Illinois*, Staff added 30 basis points to its recommendation beyond that for risk.

Adding only 244 basis points for an equity risk premium to the current 8.13% yield on public utility bonds would result in a DCF value of 10.6% in the instant case. Even this simple exercise to achieve parity with the order in *Consumers Illinois* would result in an upward adjustment to Staff's DCF calculation to 10.6%, resulting in a cost of equity of 10.6% (10.5-10.6=10.6).

Staff's initial brief asserts that the three "bottom dwellers" (Connecticut Water, Middlesex Water and Pennichuck) should not be deleted because they are closest in risk to the Company (p. 17–18). The source of this fiction is unclear. Mr. McNally has admitted that American States and Philadelphia Suburban are closest in risk to the Company (T. 300; Staff Exhibit 3.0, Schedule 3.4).

Finally, Staff's initial brief acknowledges that elimination of the water company sample would increase the cost of common equity calculation (Staff initial brief, p. 18). However, Staff has gone only part way. It must also delete the three companies from the comparable sample, as

was done in the *Consumers Illinois* case. That would result in a cost of equity of 11.1% (Company initial brief, p. 7).

b. Alternatively, Even If Low DCF Values Are Retained, Staff's Calculation Is Biased

Mr. Moul presented evidence that Staff has introduced a downward bias in its DCF calculation by giving extra weight to the DCF values for the three companies below the yield on A–rated public utility bonds (Company Exhibit R–7, p. 8). In point of fact, Staff has given a 38.10% weight to the DCF values of these three "bottom" companies (*Id.*; Schedule 1, Company Exhibit R–8, p. 1). These three companies are included in both the water utility sample and the comparable public utility sample, and in both the low–end estimate and the high–end estimate (*Id.*, pp. 8–9). There is only a low–end estimate for each of these three companies, yet Mr. McNally has included the same low–end estimate as a high–end estimate as well (Staff Exhibit 3.0, Schedule 3.8). Staff has double–counted the same DCF values for these three companies, using growth forecasts from the same analyst.

If the low–end estimates for these three companies are removed from the high–end estimates, Staff's cost of common equity would become as follows:

	Original Staff	Revised Staff
Range	9.9%-10.5%	10.5%-11.0%
Midpoint	10.2%	10.8%

(Company Exhibit R–7, p. 9.)

Going one step further, if each DCF value is given equal weighting, and the DCF values below the yield on A–rated public utility bonds are removed, Staff's cost of common equity would become as follows:

	Original Staff	Revised Staff
Range	9.9%-10.5%	10.5%-11.43%
Midpoint	10.2%	11.0%

(*Id*., p. 10.)

On its face, Schedule 3.8 of Staff Exhibit 3.0, is misleading. When the same DCF value is said to be at the same time a low–end and high–end estimate, the statement is a self contradiction. In reality, Mr. McNally did not develop true high–end estimates because his "high–end" averages are biased downward by inclusion of low–end numbers. Thus, the "high–end" estimate is a misnomer. It is impossible for a single value to be both a low–end and high–end estimate.

To demonstrate how distorted Mr. McNally's high–end estimate is, consider the following:

1. Five out of the nine "high–end" estimates in the comparable sample and five out of seven of the high–end water sample estimates are also low–end estimates.

2. If low–end estimates were deleted from the high–end column, the high–end DCF value for the comparable sample would increase to 12.63% and for the water sample, to 12.38%.

c. Alternatively, Staff's DCF Calculation Is Flawed Because Staff Did Not Use *Value Line* Forecasts of Growth

Mr. Moul pointed out that Staff failed to use *Value Line* earnings growth forecasts in its DCF models (Company Exhibit R-7, pp 14-15). Had it done so, with elimination only of the three "bottom" companies in Staff's comparable sample, Staff's DCF calculation would increase

to 12.17% for its comparable sample and 11.66% for its water utility sample. (Company Exhibit R-8, Schedule 3, p. 2).

Staff's initial brief asserts that *Value Line* forecasts have a shorter time horizon (p. 21). Yet, on cross-examination, Mr. McNally admitted that *Value Line* forecasts four to six years, which is as long, if not longer, than IBES and Zacks. (T. 314).

Moreover, according to the order in *Commonwealth Edison Company,* Docket No. 90-0169, Mr. Pregozen, Mr. McNally's supervisor, used *Value Line* growth rates in his DCF calculation presented in that case.

d. Staff's CAPM Calculation Is Flawed Because Staff Failed To Incorporate Treasury Bills

The Company has pointed out that Staff suddenly has abandoned its use of Treasury Bills in developing its CAPM (Company initial brief, pp. 9–12). Staff's change is inconsistent with Commission policy, for several reasons:

1. In the past three years, the Commission consistently has approved Staff's use of Treasury Bills in its CAPM calculation, as appears on the face of the Commission's rate orders. In fact, in *United Cities Gas Company,* Docket No. 00–0228, Staff used Treasury Bills in its direct testimony dated July, 2000, one month prior to Staff's direct testimony in the instant case. The Commission approved Staff's position in its rate order in that case.

2. Staff's determination to use Treasury Bonds is based upon an erroneous assumption that the inflation rate will be 2.7% (*See* Company initial brief, pp. 10–12). The Company has pointed out that the current inflation rate is 3.5%. In addition to the authorities cited at p. 11 of the Company's initial

brief in support of administrative notice, the Commission also should note *Island Lake Water Co. v. Illinois Commerce Commission*, 65 Ill. App. 3d 853 (2d Dist. 1978). The court stated that it may take notice of economic data by reference to authoritative tabulations of such data. It specifically took notice of the rates of inflation as issued by the Bureau of Labor Statistics Consumer Price Index.

Staff asserts that historical inflation rates are irrelevant. Staff is wrong. Current data indicates that Staff's assumption of the future rate is erroneous. The point is that if the inflation rate is 3% or more, it would compel Staff to use Treasury Bills under its methodology (Company initial brief, p. 10).

3. Staff used Treasury Bills for its risk free rate of return in calculating its beta for the CAPM (*Id.* at p. 22; T. 313).

4. The Commission used Treasury Bills to set the rate of interest of 6% to be paid on all customer deposits for the next calendar year (Order, Docket No. 00-0228, December 6, 2000).

If Mr. McNally had used Treasury Bills, his CAPM value would be 10.8%. Together with corrections to his DCF calculation to be consistent with the *Consumers Illinois* case as discussed above (Section II B1), Staff's corrected cost of common equity would be:

	Original Staff	Revised Staff
Range	9.9%-10.5%	10.8%-11.7%
Midpoint	10.2%	11.25%

Staff's calculation of cost of common equity, when so corrected, equals the 11.25% requested by the Company!

e. Staff's CAPM Calculation Is Flawed Because Staff Failed To Consider *Value Line* Betas

As Mr. Moul explained, the other problem with Staff's CAPM calculation is Mr. McNally's use of betas that do not conform with data used by investors (Company Exhibit R–7, p. 16; Company initial brief, pp. 12–14).

Staff's initial brief also asserts that *Value Line* may not be complete (p. 22). However, in point of fact, Staff **has** used *Value Line* betas in its CAPM calculations in prior rate cases. In *Illinois–American Water Company*, Docket No. 95–0076, the Commission's order states that Staff witness Walter used *Value Line* betas. In *Illinois Bell Telephone* Company, Docket No. 92–0448 and 93–0239 Cons., the Commission's order states that Staff witness Nicdao used *Value Line* betas. In *Commonwealth Edison Company*, Docket No. 90–0169, the order states that Staff witness Pregozen, Mr. McNally's supervisor, used *Value Line* growth rates in his DCF calculation and *Value Line* betas in his CAPM. In *United Cities Gas Company*, Docket No. 90–0008 and 90–0152 Cons., the order states that Staff witness Rungren used *Value Line* betas. *Commonwealth Edison Company*, Docket Nos. 87–0043, 87–0044, 87–0057 and 87–0096 Cons., the order states that Mr. Pregozen used *Value Line* betas. In *Lake Holiday Utilities* Corporation, Docket No. 86–0342, the order states that Mr. Pregozen used *Value Line* betas. See, also, *Consumers Gas Co.*, Docket No. 89–0036.

Mr. Gorman stated that he used *Value Line* betas in the instant case because it was a published source that estimates betas for the water utility group (T. 264). He said that a beta should be used which is likely to reflect the market's assessment and the systematic risk of the security (T. 265). He affirmed his prior statement referenced in the *Commonwealth Edison* order, Docket No. 94–0065, that "the correct beta should be reflective of that likely to be used by the market in general in the application of a CAPM analysis and not simply a beta which an individual analyst or investor would find preferable." (T. 265).

Staff's initial brief claims that its beta does not have to be derived from information used by investors (p. 22). Staff's claim is contradicted by its own statement that "DCF methodology requires a growth rate that reflects the expectations of investors." (Staff initial brief, p. 10). Staff's claim also is erroneous. Necessarily, a realistic CAPM must reflect data used by investors. "As to betas, the *Value Line* publication represents the obvious choice for the beta component of the CAPM," Mr. Moul stated. "*Value Line* is probably the most widely used source of investment advice. As shown on Exhibit R–8, Schedule 5, I have provided the *Value Line* published betas that provide the measure of systematic risk that influence the investors in water utility stocks." (Company Exhibit R-7, p. 18; *see also* pp. 14–15).

Staff asserts that *Value Line* does not give betas for all companies in Staff's samples (Staff initial brief, p. 22). However, Staff included Artesian Resources, for which no IBES estimate was available.

If *Value Line* betas were used in Mr. McNally's CAPM calculation, without deleting the three companies with DCF values below the yield on A–rated public utility bonds, Staff's CAPM would become:

	Rf +	(Rm – Rf) =	k
Water Sample	5.81+	.54 (16.24-5.81) =	11.44%
Comparable Sample	5.81+	.55 (16.24-5.81) =	11.55%
Average			11.50%

If the three companies are deleted, the CAPM for both samples becomes:

5.81+ .58 (16.24-5.81) = 11.86%

If Treasury Bills are used instead of Treasury Bonds, and *Value Line* Betas are used, the CAPM becomes:

Water Company Sample	6.40 + .54 (16.24-6.40)	=	11.71%
Comparable Sample	6.40 + .55 (16.24-6.40)	=	11.81%
Average			11.76%
Three Companies Deleted	6.40 + .58 (16.24-6.40)	=	12.11%

Any of these corrections to Staff's CAPM calculation, when coupled with the correction to Staff's DCF calculation to be consistent with the *Consumers Illinois* case, will produce a Staff cost of common equity which equals or exceeds the cost of common equity requested by the Company. For example:

(1) Use of Treasury Bills instead of Treasury Bonds

Range	10.8%	-	11.7%
Midpoint	11.25%		

(2) Use of *Value Line* Betas

Range	10.6%	-	11.7%
Midpoint	11.7%		

(3) Use of *Value Line* Betas, deleting three companies

Range	11.8%	-	11.9%
Midpoint	11.9%		

(4) Use of *Value Line* Betas and Treasury Bills

Range	11.8%	-	11.8%
Midpoint	11.8%		

(5) Use of *Value Line* Betas, deleting three companies, and Treasury Bills

Range	11.8%	-	12.1%
Midpoint	12.0%		

3. Fairness Compels The Corrections To Staff's And Intervenor's Calculations Of Cost Of Common Equity

The Company's initial brief demonstrated that corrections are necessary to Staff's and IIWC's calculations of cost of common equity for three reasons:

1. To assure consistent treatment with the policy of the Commission to discard DCF values below the yield of A–rated public utility bonds. *Consumers Illinois* order, Docket No. 99–0238.

2. To assure the comparable earnings test is satisfied by producing a cost of common equity reasonably greater than the yield on A–rated public utility bonds. In this connection, Staff's cost of equity recommendation in the instant case is far **lower** than its recommendation, accepted by the Commission, in the *Consumers Illinois* case.

	Consumers Illinois	Illinois–American
ROE recommendation	10.5%	10.2%
Bond yield	7.85%	8.13%
Difference	2.65%	2.07%
% Difference	28% higher	

3. Corrections are necessary to assure reasonable credit quality by providing pre–tax coverage adequately within the Standard & Poor benchmark for A–rated bonds. Only a slight erosion of the return recommended by Staff or IIWC would result in the Company falling into a BBB category. Contrary to Staff's assertion, the return requested by the Company would place it about the midpoint of Staff's 2.8 to 3.4 range for an A rating. Both Staff and IIWC would place the Company in the bottom quarter, almost on the threshold of BBB.

(*See* Company initial brief, pp. 19–21).

Staff distorts reality when it asserts that Standard & Poor does not require a pre–tax interest coverage ratio of 2.8x to 3.4x to maintain A rating (Staff initial brief, p. 24). The fact is that Standard & Poor's benchmark for A rating pre–tax interest coverage **is** 2.8x to 3.4x. Moreover, the mean and median values of 2.81 and 2.89 cited by Staff are for companies whose earned return on equity is 9.28 and 9.30, according to the source cited by Staff. That situation obviously does not apply here.

4. Staff's Criticisms Of Mr. Moul Must Be Disregarded

Staff's initial brief, pp. 24–29, criticizes portions of Mr. Moul's presentation. However, its assertions are misplaced. While Mr. Moul's analysis supports the Company's requested rate of return on common equity, the Company's request is significantly below the results of his analysis. Staff's own errors, discussed above, belie the credibility of its criticisms. Regardless, Staff's assertions are erroneous:

a. Historical Data

Staff's initial brief criticizes Mr. Moul for using historical data (p. 24–25). This criticism is absurd. Staff witness McNally himself used historical data,

- to develop his comparable samples;
- to develop his beta;
- to determine the reasonableness of the capital structure;
- to determine dividend changes.

(T. 296–297).

In his rebuttal testimony, Mr. Moul explained why he used historical data.

"Historical data is the most widely analyzed data for investigating and testing theories explaining the functioning of the capital markets. Indeed, most of the notable academic research has used historical data in this regard. Indeed, in the recent Fama/French studies that have received wide- spread attention, 28 years of historical monthly data was used in this research. Moreover, I doubt that any serious investor would commit to a common stock investment without first apprising himself/herself of the historical performance of a company. Lastly, Mr. McNally has used historical data extensively in the process of selecting his comparable utility companies.***

"As previously explained, the use of an average helps deal with the vagaries of the market which can produce anomalous results when spot, or one-day stock prices are used in the DCF. Moreover, historical data is more reflective of the types of data used in utility ratesetting and avoids the gamesmanship that can occur with the use of spot data.***

"First, if it is accepted that the market for equities is informationally efficient, at least in the long- run, then investor expectations for the future can be discerned from past data. That is to say, 71-years of data contains so much information about investor expectations that it is doubtful that future market returns have not already been captured by the historical data."

(Company Exhibit R–7, pp. 21-22).

Staff's initial brief asserts that spot prices are more accurate than historic perspective (Staff initial brief, pp. 18–20). Staff presented no evidence that the spot prices it used in the day it selected will be representative of the period in which the new rates will be in effect. In reality, Staff's DCF calculation is based on historic data derived on one day last August. It is, therefore, less reliable than the broader perspective presented by Mr. Moul.

b. Risk Premium Analysis

Staff criticizes Mr. Moul's risk premium analysis (Staff initial brief, p. 25). However, Mr. Moul responded to Staff's assertions in his rebuttal testimony, Exhibit R–7, as follows:

> "First, the historical data that I used for developing the equity risk premium for the S&P Public Utilities is entirely appropriate for reasons explained above. Second, the A bond rating provides the most common representation of the credit quality rating for investment grade public utility bonds. Indeed the average bond rating for the companies in the S&P Public Utilities index is A. Moreover, the Lehman Brothers index of public utility bond returns includes investment grade rated bonds -- the most common rating being A for that category. Third, I have specifically tailored my equity risk premium to the market fundamentals most likely to exist for the future. It is for this reason that I gave greatest emphasis to the more recent data covering the periods 1974-1999 and 1979-1999. As to my selection of a utility equity risk premium, I have taken a balanced approach by utilizing a premium for the S&P Public Utilities which is between the lowest premium and the highest premium." (*Id*. at pp. 22–23).

c. CAPM Analysis

At pages 25–26 of Staff's initial brief, Staff criticizes Mr. Moul's CAPM analysis. None of these assertions are in the record and, therefore, should be disregarded.

Staff criticizes Mr. Moul's use of historic data to develop his CAPM values. However, as noted above, Section IIB4a, Mr. McNally did the same thing. He replied upon historic data.

Staff asserts that Mr. Moul overstates total market return. The fact of the matter his median total return of 18.03% is only slightly above Mr. McNally's own calculation of 16.24%. Moreover, Staff presented no evidence that the 15.83% price appreciation forecast used by Mr. Moul was not applicable to dividend paying stocks.

Finally, Staff asserts that the *Value Line* forecast is only for a 3–5 year time line. However, on cross–examination, Mr. McNally admitted *Value Line* projects four to six years (T. 313). Clearly, the *Value Line* projections are valid for rates expected to be in effect for the next two or three years. As pointed out above Section IIB3e, Staff has used *Value Line* forecasts in prior cases for years.

Mr. Moul explained his methodology as follows:

> "The data and underlying calculations that support my risk premium calculation for the S&P Public Utilities have been repeatedly scrutinized by various staff analysts and intervenors' consultants for over 15 years. While the conclusions that I have drawn from these data may have been disputed by opposing parties, the underlying data and calculations have not been challenged. Indeed, with exception of one year-end index value, Mr. McNally and I are in agreement as to the basic data that underlies the values for the S&P Public Utilities. The basic difference relates to the methods used to calculate the annual returns. My calculations use a more detailed monthly approach whereby the annual return is represented by the geometric progression of the actual monthly returns. This procedure conforms with the theoretically correct method that is detailed in the Ibbotson & Associates publication Stocks, Bonds, Bills and Inflation. Mr. McNally has employed an abridged approach using annual data that is less detailed and does not conform with the generally accepted manner in which total market returns are usually calculated. For this reason, Mr. McNally's calculations provide only a rudimentary representation of the actual market returns." (Company Exhibit R–7, pp. 23–24).

Further, Mr. McNally used monthly data to compute his betas (see Staff Exhibit 3.0, p. 22, lines 418-419), yet he reverts to annual data in analyzing Mr. Moul's data.

d. Comparable Earnings

Staff's initial brief questions the value of Mr. Moul's comparative earnings presentation (pp. 26–27). However, Mr. Moul responded fully to Staff's assertions in his rebuttal testimony:

> "The Comparable Earnings approach was established in the landmark Bluefield & Hope decisions, which set forth the two principal standards of a fair return, namely, comparability and capital attraction. In the Hope decision, the United States Supreme Court defined these requirements as: '...by that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital.' The Comparable Earnings approach directly considers those requirements and, in addition, has considerable intuitive appeal because it fits the established standards for a fair rate of return set forth in the Bluefield and Hope decisions. This approach has been used by me in connection with the other market models (i.e., DCF, Risk Premium, and CAPM) and the combined results of all methods fulfill both established standards of a fair rate of return. The financial community has expressed the view, as indicated by a noted Merrill Lynch analyst, that the regulatory process must consider the returns that are being achieved in the non-regulated sector to ensure that regulated companies can compete effectively in the capital markets.
>
> "The underlying premise of the Comparable Earnings method is that regulation should emulate results obtained by firms operating in competitive markets and that a utility must be given an opportunity cost of capital equal to that which could be earned if invested in firms of comparable risk. Further, given the 10 year time frame (i.e., five years historical and five years projected) considered by this study, it is unlikely that the earned returns of non-regulated firms would diverge significantly from their cost of capital. For non-regulated firms, the cost of capital concept is used to determine whether the expected marginal returns on new projects will be greater than the cost of capital, i.e., the cost of

capital provides a hurdle rate for new projects. Since the Comparable Earnings method is derived from a firm's overall performance (i.e., its average return), it is likely that the approach has measured blended returns on a variety of projects that have produced returns above and below the cost of capital during the measurement period."

(Company Exhibit R–7, pp. 25–26).

Staff forgets that the comparable earnings test is mandated by Illinois law. *Peoples Gas Light and Coke Co. v. Slattery*, 373 Ill. 31 (1939); *Island Lake Water Company v. Illinois Commerce Commission*, 65 Ill. App. 3d 853 (2nd Dist. 1978). The law does not limit "comparable earnings" to comparison with other regulated companies. In fact, the above cited cases specifically made comparisons with securities of unregulated entities.

Staff also implies that there may be accounting practice differences between companies. This assertion is nonsense, as all companies must comply with GAAP (generally accepted accounting principles).

e. Leverage Adjustment

Staff's initial brief asserts that Mr. Moul's use of a leverage adjustment is incorrect (pp. 27–28). Mr. Moul explained the basis for his adjustment in financial theory (Company Exhibit 7.0, p. 58). Mr. Moul then explained why he made the adjustment:

"I have explained in my direct testimony the reasons that the regulatory determined cost of equity must be adjusted for the book value measures concerning the market models, such as DCF and CAPM. The Hamada formula that I used to adjust the betas is merely an extension of the Modigliani and Miller formula that I used in the DCF calculation. It must be recognized that in order to make the DCF and CAPM results relevant to the rate

base measured at original cost, the market derived cost rate cannot be used without modification. My adjustment comes into play when market values exceed book values, thereby indicating less leverage when measured with market values than that which exists in a capital structure that is measured with book values. As a factual matter, Messrs. McNally and Gorman do not dispute the fact that, using the market values, my Water Group had a 63.62% equity ratio and my Public Utility Group had a 66.24% equity ratio. Those ratios compare with an equity ratio measured at book value of 47.07% for the Water Group and 49.19% for the Public Utility Group. The DCF and CAPM calculation represents the returns that investors expect on their market value, and it is not a book value determined return. My adjustment is necessary to convert the market returns related to price into earned returns related to book value. My leverage adjustment is not intended, nor was it designed, to address the reasons that stock prices are different from book values." (Company Exhibit R–7, p. 24).

The capital structure ratios cited by Mr. Moul were not challenged by Staff (Company Exhibit 7, p. 56).

Incidentally, Staff has made similar adjustments to cost of common equity without any theoretical basis whatsoever. For example, in the *Consumers Illinois* case, Docket No. 99–0288, Staff added 30 basis points to its recommendation to reflect risk and expanded its range by 80 basis points (Staff Exhibit 3.0).

f. Size Premium

Staff has criticized Mr. Moul's size adjustment (Staff initial brief, p. 28). Mr. Moul addressed Staff's assertions in his rebuttal testimony. "First, Mr. McNally says that the Company's parent, American Water Works ("AWW"), should serve as the basis for the size adjustment. The market capitalization of AWW was $2.7 billion which places it in the third

decile of companies on the NYSE, which makes it a mid-cap company. The mid-cap adjustment is 0.19%. Yet, I find it curious that Mr. McNally has not used AWW as his sole basis to measuring the Company's cost of equity. As to Mr. McNally's other complaints, I have already addressed the issue of historical-based data and will not repeat my response here. Second, utilities were included in the Ibbotson analysis of the returns on stocks listed on the NYSE, thereby negating Mr. McNally's criticism of that issue. Finally, the adjustment for the betas relates to regression bias and has nothing to do with the issue of size." (Company Exhibit R–7, p. 26).

Staff asserts that the size–based risk premium was developed from stocks listed in the New York Stock Exchange, which is heavily weighted with industrial stocks (Staff initial brief, p. 20). However, it also includes utility stocks. Moreover, Mr. McNally developed his total market return from analysis of both industrial and utility stocks.

5. Conclusion

The Company has proposed a rate of return on common equity of 11.25%. Its request is supported by Mr. Moul's analysis, which actually would justify a higher number. The Company has chosen a lower number to mitigate rate impacts.

Staff's presentation is flawed in several respects, causing its recommendation to understate the Company's cost of common equity. In particular, Staff has not treated the Company in the same manner as it treated Consumers Illinois in its recent rate case.

The Commission should find that 11.25% is a reasonable and proper rate of return on equity in this proceeding.

C. The Commission Should Adopt The Company's Proposed Depreciation Rates For Services

The Company and Staff have reached agreement on new depreciation rates, except for services. The Company has proposed a rate of 6.49% for services, resulting from a salvage value of (-300%). Staff has proposed 3.85%, based upon a salvage value of (-150%).

The Company's initial brief, pp. 21–23, demonstrates why the Commission should adopt the Company's proposed rate, and make corresponding adjustments to depreciation expense, accumulated depreciation and deferred income tax.

Staff witness King presented no evidence to support his proposed rate. In fact, he acknowledged that his assumed salvage value was understated (Staff Exhibit 10.00, pp. 7–8).

Staff's initial brief does not address this issue. Accordingly, the Company assumes that Staff has conceded that the Company's proposed depreciation rate for services is appropriate.

D. The Commission Should Adopt The Company's Rate Design Proposals

1. The Commission Should Approve An Across–The–Board Rate Increase

The Company has proposed that, in this proceeding, rates be established on an across–the–board basis. The Company has made this proposal to mitigate rate impacts on large volume customers who may have the potential to leave the system or to reduce demand.

Alternatively, the Company has proposed that the rates for its single–tariff pricing group be set across–the–board, with rates for Champaign and Sterling District be set based on Staff's cost of service study. IIWC agrees with the Company's alternative proposal.

Staff continues to advocate its cost of service study for all of the subject districts (Staff initial brief, pp. 29–36). However, Staff acknowledges that its proposed rates really are **not** based on its cost of service study.

1. "While Staff's rates are not set at full cost–of–service . . ." (p. 34).

2. "So he limited the impact by spreading costs to other classes." (p. 35).

3. "His adjustments lowered the overall increase to the industrial class . . ." (p. 35).

The Company welcomes the adjustments Staff has made to its cost of service study. However, the reality is that Staff's proposed rate design is **not** based on its cost of service study, but on the concerns expressed by both the Company and IIWC as to rate impacts on large users.

Since Staff agrees that mitigation of rate impacts is the paramount concern, then it should concede that an across–the–board approach – at least for the single–tariff pricing group – will best satisfy this concern.

Staff's approach has so modified its cost of service study that it cannot be seriously said that its proposed rates are even related to that study. For example, the chart on page 35 of Staff's initial brief reveals that Staff's proposed rebuttal rates for the Southern Division have moved from cost of service rates to almost uniform rates.

2. The Commission Should Approve The Alton Source Of Supply Charge

The Company has proposed the Alton Source of Supply Charge to mitigate rate impacts of the new Alton treatment facility on customers within the single–tariff pricing group but outside of the Alton District.

The proposed charge in no way militates against the single–tariff pricing concept, as Staff asserts (Staff initial brief, pp. 36–37). Rather, it is consistent with single–tariff pricing.

The charge is premised upon comparative investment per customer within the single–tariff pricing group. It is an acknowledgement that the huge $38 million investment in the Alton treatment facility would distort comparative investment in the absence of the proposed charge.

IIWC's objection to the proposed charge, cited by Staff, makes no sense. All of the members of IIWC are within the single–tariff pricing group and outside of the Alton District. Accordingly, they would benefit from the proposed charge (*See* Section IIIC, *infra*.).

III.

REPLY TO IIWC INITIAL BRIEF

A. Introduction

The so–called Illinois Industrial Water Consumers ("IIWC") has filed an initial brief. However, IIWC is confused as to its composition.

As the record shows, IIWC constitutes only three companies: Cerro Copper Products, Granite City Steel and Elementis Pigments.* IIWC's initial brief, however, incorrectly states that IIWC includes additional companies Caterpillar, Northwestern Steel & Wire and Owens–Illinois. These additional companies are not parties to the case and all references to them should be stricken from IIWC's initial brief.

B. IIWC Agrees With The Company's Alternative Rate Design Recommendation

The Company has proposed that the rate increase be assigned "across–the–board" so as to mitigate impacts on large volume customers who may have the potential to leave the Company's system or to reduce demand (*See* Company initial brief, pp. 24–25).

* Laclede Steel withdrew its intervention on October 13, 2000.

As an alternative, the Company has recommended that rates be determined across–the–board for its single–tariff pricing group, with rates determined for the Champaign and Sterling Districts based upon Staff's most current cost of service study (Company Exhibit R–1, p. 11).

IIWC witness Gorman and IIWC's initial brief support the Company's alternative proposal (Gorman Rebuttal, IIWC Exhibit 2.0, pp. 5, 9–10; IIWC initial brief, p. 11). IIWC's position is based upon its concern, which also is the Company's concern, over the potential for large volume customers to leave the system.

C. IIWC's Position On The Alton Source Of Supply Charge Is Incomprehensible

IIWC opposes the Company's proposed Alton Source of Supply Charge (IIWC initial brief, p. 14). Its opposition is curious.

IIWC acknowledges that the purpose of the proposed charge is to mitigate the rate impact of the new Alton treatment facility on customers within the single–tariff pricing group who are outside of the Alton District. (*Id*.)

All three members of IIWC are within the Company's Interurban District, which is within the single–tariff pricing group. Therefore, all three clearly would benefit from the proposed Alton Source of Supply Charge. IIWC will pay higher rates if its position were adopted by the Commission. Therefore, IIWC's position cannot be taken seriously.

D. IIWC's Proposed Cost Of Common Equity Should Be Disregarded

IIWC's testimony on the Company's cost of common equity is seriously flawed, and should be disregarded because of two major errors by its witness Michael Gorman:

1. He improperly included E–Town Corporation, an acquisition target, in his sample of companies for determination of his DCF and CAPM values. E–Town no

longer exists as an independent company with traded stock. This error totally distorted his calculations, causing him to seriously understate the Company's cost of common equity.

2. He improperly computed his CAPM values by using the wrong *Value Line* betas, inappropriate understated market returns, and Treasury Bonds instead of Bills.

(*See* Company initial brief, pp. 15–19.)

When Mr. Gorman's calculations are corrected, his recommended cost of equity becomes **greater** than the 11.25% requested by the Company:

		Range	Midpoint
1.	Original	9.98%-10.1%	10.0%
2.	Eliminate E–Town	10.14%-11.24%	10.7%
3.	Also Use Proper Betas and Correct Market Return	10.7%-12.04%	11.37%
4.	Also Use Treasury Bills	10.7%-12.21%	11.46%

(*See* Company initial brief, pp. 16–19.)

IIWC's initial brief asserts that IIWC's position differs from Staff's position in only one respect. IIWC is wrong. IIWC's position differs in several respects:

First, Staff explicitly excluded E–Town from its calculations because E–Town is an acquisition target (Company initial brief, pp. 16). That Mr. Gorman's inclusion of E–Town in his sample is a serious mistake is beyond question. Both Mr. Moul and Mr. McNally agreed that E–Town must be deleted (Company initial brief, pp. 16–17). Moreover, E–Town was acquired by Thames Water on November 29, 2000. E–Town no longer exists as an independent company with traded stock.

In his rebuttal testimony, Mr. Gorman made the silly assertion that, if E–Town is deleted, then Philadelphia Suburban also should be deleted (IIWC initial brief, p. 26). What he really has asserted is that, if the low DCF value is deleted, then the high DCF also should be deleted.

Again, Mr. Gorman misses the point. Determining cost of common equity is not a game. E–Town must be deleted because it does not belong in a sample. Its stock price is distorted by a contractual premium, which distorts its DCF value. Moreover, E–Town must be **rejected** for the further reason that its DCF value is well below the Company's cost of debt and the yield on A–rated public utility bonds (*See* Company Exhibit SR–2, pp. 6–7).

On the other hand, there is no reason whatsoever to exclude Philadelphia Suburban. Mr. Moul explained why Philadelphia Suburban's growth is sustainable: "First, Mr. Gorman's assertion that PSC's earnings growth rate might slow is misplaced. There are approximately 55,000 separate investor–owned and municipal water utility systems in the US. This very large pool of potential acquisition targets provides an enormous opportunity for PSC and other water companies to continue to attain strong earnings growth during the "roll up" of the water utility industry. Indeed, American Water Works, parent of Illinois–American, also has reaped the benefits of growth through acquisition. Moreover, the dividend yields of these companies reflect that fact. Remember, the DCF return is comprised of both a dividend yield and growth components. To focus solely on the growth rate ignores the dividend yield component that includes the price of stock that reflects the high growth prospects of the survivors in the "roll–up" process." (*Id*.)

Indeed, Mr. McNally found that, among water companies, Philadelphia Suburban was one of two companies closest in comparability to the Company (T. 300).

Second, in developing its CAPM, Staff calculated a **current** market return of 16.24%, using a methodology adopted by the Commission for many years. In fact, Mr. Gorman used this methodology himself when he was a Staff member in 1989. He acknowledged that this methodology produces 16.24%. On the other hand, Mr. Gorman admitted that he used **historic** market returns of 13.0 to 13.8% in the instant case under an unsubstantiated methodology (Company initial brief, pp. 17–18). Mr. Gorman's CAPM calculation is a hodgepodge: **historic**

market return; **current** Treasury Bond yield; assumed future **inflation** rate. His calculation simply is not credible.

IIWC's criticism of the Company's requested return on common equity is misplaced (IIWC initial brief, pp. 18–24).

First, Company witness Moul did **not** recommend 11.25%. He performed DCF, Risk Premium, CAPM and Comparable Earnings calculations which indicate a much higher cost of equity. The Company has requested a lower midpoint 11.25% to mitigate the rate impact of this proceeding (Company initial brief, p. 3).

Second, both the Staff and IIWC calculations, when corrected, equal or exceed the 11.25% requested by the Company (Company initial brief, pp. 2–21).

Third, IIWC's initial brief disputes the fact that the Company faces risks (*Id*., pp. 18–19). Its assertion is unbelievable, since IIWC vigorously asserts that the Company faces a serious risk from competition and loss of large volume customers (IIWC initial brief, pp. 4–13).

In addition, IIWC overlooks Company Exhibits 1.1, 1.2 and 1.3, which address water utility increased risks. The one–time, relatively limited mercury situation of Northern Illinois Gas Company cited by IIWC hardly compares with the ongoing risk water utilities experience to provide safe water. The well–publicized Milwaukee *cryptosporidium* incident, involving many deaths and thousands of injuries, illustrates this fact. IIWC forgets that water is ingested.

Moreover, IIWC forgets that the investment per customer for a water utility exceeds that for any other type of utility (Company Exhibit 1.0, p. 18).

That electric utilities in a deregulated environment may be subject to a "rate freeze" is irrelevant. By having an opportunity to conduct deregulated operations, these utilities also have the opportunity to earn a deregulated higher rate of return.

IIWC's initial brief asserts that Mr. Moul's leverage adjustment to his DCF calculations should be rejected (*Id.*, pp. 19–20). Mr. Moul, in his rebuttal, explained why his adjustment is appropriate: "I have explained in my direct testimony the reasons that the regulatory determined cost of equity must be adjusted for the book value measures concerning the market models, such as DCF and CAPM. The Hamada formula that I used to adjust the betas is merely an extension of the Modigliani and Miller formula that I used in the DCF calculation. It must be recognized that in order to make the DCF and CAPM results relevant to the rate base measured at original cost, the market derived cost rate cannot be used without modification. My adjustment comes into play when market values exceed book values, thereby indicating less leverage when measured with market values than that which exists in a capital structure that is measured with book values. As a factual matter, Messrs. McNally and Gorman do not dispute the fact that, using the market values, my Water Group had a 63.62% equity ratio and my Public Utility Group had a 66.24% equity ratio. Those ratios compare with an equity ratio measured at book value of 47.07% for the Water Group and 49.19% for the Public Utility Group. The DCF and CAPM calculation represents the returns that investors expect on their market value, and it is not a book value determined return. My adjustment is necessary to convert the market returns related to price into earned returns related to book value. My leverage adjustment is not intended, nor was it designed, to address the reasons that stock prices are different from book values." (Company Exhibit R–7, p. 24).

IIWC asserts that Mr. Moul's public utility sample is not comparable to the Company because the sample has a slightly higher risk premium and a slightly higher beta (IIWC initial brief, p. 20). IIWC's assertion begs the question. Mr. Moul selected a sample of public utility companies which are comparable to the Company. He then determined their risk premiums and betas. This is the same approach as Staff has taken, and as Mr. Gorman took when he was a Staff member. If the risk premiums and betas for a public utility group always were identical as those of a water group, there would be no need to analyze a public utility group.

IIWC objects to Mr. Moul's comparable earnings analysis (IIWC initial brief, pp. 23–24). Its objection is without merit. As Mr. Moul explained, "The Comparable Earnings approach was established in the landmark Bluefield & Hope decisions, which set forth the two principal standards of a fair return, namely, comparability and capital attraction. In the Hope decision, the United States Supreme Court defined these requirements as: "...by that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital." The Comparable Earnings approach directly considers those requirements and, in addition, has considerable intuitive appeal because it fits the established standards for a fair rate of return set forth in the Bluefield and Hope decisions. This approach has been used by me in connection with the other market models (i.e., DCF, Risk Premium, and CAPM) and the combined results of all methods fulfill both established standards of a fair rate of return. The financial community has expressed the view, as indicated by a noted Merrill Lynch analyst, that the regulatory process must consider the returns that are being achieved in the non–regulated sector to ensure that regulated companies can compete effectively in the capital markets.

"The underlying premise of the Comparable Earnings method is that regulation should emulate results obtained by firms operating in competitive markets and that a utility must be given an opportunity cost of capital equal to that which could be earned if invested in firms of comparable risk. Further, given the 10 year time frame (i.e., five years historical and five years projected) considered by this study, it is unlikely that the earned returns of non–regulated firms would diverge significantly from their cost of capital. For non–regulated firms, the cost of capital concept is used to determine whether the expected marginal returns on new projects will be greater than the cost of capital, i.e., the cost of capital provides a hurdle rate for new projects. Since the Comparable Earnings method is derived from a firm's overall performance (i.e., its

average return), it is likely that the approach has measured blended returns on a variety of projects that have produced returns above and below the cost of capital during the measurement period." (Company Exhibit R–7, pp. 25–26).

The Comparable Earnings test is well–established in Illinois law. "It seems to us fair to assume that if the company could take a sum equivalent to the value of its property and invest it soundly, so as to insure a rate of return in excess of the return authorized by the commission, this should be proof, or at least evidence, of confiscation . . ." *Peoples Gas Light and Coke Co. v. Slattery*, 373 Ill. 31, 68 (1939); *Island Lake Water Company v. Illinois Commerce Commission*, 65 Ill. App. 3d 853 (2d Dist. 1978).

IIWC unsuccessfully attempts to defend Mr. Gorman's failure to use *Value Line* earnings growth estimates (IIWC initial brief, pp. 27–28). As Mr. Moul explained in his surrebuttal testimony, assertions by both Mr. Gorman and Mr. McNally to ignore *Value Line* are not persuasive.

"To ignore these inputs in the DCF calculation is equivalent to repudiating the investors' assessment of these companies that are reflected in the prices that they have used to calculate the cost of equity. All witnesses have given primary emphasis to forecasts of earnings per share growth -- Mr. Gorman's belated reference to the dividend growth forecast by *Value Line* is clearly misplaced given the constant P/E multiple assumption of the DCF model and the fact that dividend payout ratios are forecast to decline in the future for the water company stocks. Importantly, since *Value Line* has an influence on the investors that price the common stocks of the water companies, then these data must be used to estimate the growth reflected in the stock price, otherwise the DCF cost rate will be misspecified." (Company Exhibit SR–2, p. 8).

It is interesting that Mr. Gorman did use *Value Line* for his CAPM betas. Moreover, he acknowledged that *Value Line* provides information which investors use (T. 264–265).

IIWC erroneously alleges that Mr. Moul used "updated" betas in correcting Mr. Gorman's CAPM calculation (IIWC initial brief, p. 28). To the contrary, Mr. Moul simply used betas that matched the date of other data used by Mr. Gorman (Company Exhibit R–7, p. 18).

The Company's initial brief demonstrates that Mr. Gorman's understated calculation of cost of common equity must be corrected to assure compliance with the comparable earnings test and to assure reasonable credit quality (Company initial brief, pp. 20–21).

IIWC asserts, without support, that the Company's ratios will be adequate (IIWC initial brief, pp. 24–25). However, they will not be adequate. As Mr. Moul explained:

"Mr. Gorman offers no support for his assertion. He seems to suggest that these equity risk premiums are adequate based upon his assumption that water utilities have low risk. As to the issue of risk, S&P has assigned to the credit quality rated subsidiaries of American Water Works Company, Inc. (*"AWW"*) a business position of "3." That business position is equivalent to the ones assigned by S&P to the gas companies that include Atmos Energy, Laclede Gas, Peoples Energy, and SEMCO Energy which were components of my Public Utility Group. Hence, Mr. Gorman is incorrect that water companies necessarily possess low risk because, in these instances, the water companies have equivalent risks to the above named gas distribution companies.

"In Mr. Gorman's rebuttal, he re–computes the pre–tax interest coverage implicit in the cost of capital recommendations proposed by him and Staff. Mr. Gorman then claims that his 2.87 times pre–tax interest coverage and Staffs 2.9 times is adequate because it is above the 2.8 times threshold established by S&P for an A bond rating. What both Mr. Gorman and Mr. McNally have overlooked is the fact that the benchmark range of 2.8 times to 3.4 times represents the coverage that S&P expects a utility to actually achieve, and is distinguished from the opportunity that is provided to a utility in a rate case proceeding. For example, if there is any

erosion in the Company's achieved return, which likely will occur between rate cases, the pre–tax interest coverage actually realized by the Company will fall outside the range required for an A bond rating if the proposals of Messrs. Gorman and McNally are accepted by the Commission. This point has also been missed by Mr. McNally where in his rebuttal he purportedly compares his recommendation to the financial median of the water utilities. The pre–tax interest coverage that is necessary to sustain the Companies credit quality must be well above the bottom of the range established by S&P for an A bond rating -- my Water Group has an average A+ bond rating from S&P, and it must be viewed on a prospective basis considering the benchmark criteria, rather than a backward looking historical analysis that Mr. McNally employs in his attempt to buttress his position." (Company Exhibit SR–2, pp. 10–12).

Finally, IIWC's initial brief makes a number of misstatements.

1. It states that Mr. Gorman's water utility group was devised from water utilities followed by *Value Line* (p. 16). However, E–Town no longer exists as an independent company with traded stock.

2. It states that Mr. Gorman derived dividend growth rates from IBES (p. 17). He used *Value Line*.

3. It states that Illinois–American has a beta (p. 17). It does not.

4. It states that Mr. Gorman used the water utility group adjusted average beta (p. 17). In truth, he used out of date betas.

5. It states that Mr. Moul's adjustments will lead to "gold–plating" of plant investment (p. 21). IIWC forgets about the principles of used and useful and prudent investment.

6. It states that regulatory actions do not influence investors' required return (p. 21). To the contrary, stock prices obviously react to regulatory decisions.

7. It states that the *Value Line* growth forecast of 15.83% is unreasonable (p. 22). Yet, IIWC relies on *Value Line* for growth forecasts and betas. Moreover, total returns in 1995–1999 have exceeded 15.83% (*See* Company Exhibit 7.1, Schedule 10, p. 1).

8. IIWC implies that Mr. Moul's Treasury Bond rate was higher than financial analysts' projections (p. 22). He used the Blue Chip forecast as contained in its publication dated March 1, 2000.

9. IIWC objects to Mr. Moul's size adjustment (p. 22). However, he recognized that the Company is owned by American Water Works. The adjustment was made to both samples, which included American Water Works.

IIWC's initial brief asserts that Staff's public utility group is not comparable (p. 20). However, it was derived in a manner which Mr. Gorman used when he was a Staff member. Further, the group includes water companies. In the *Consumers Illinois* case, Docket No. 99-0238, the Commission relied solely on the public utility group because the water sample was too low compared with the yield on A–rated public utility bonds.

IV.

REPLY TO O'FALLON INITIAL BRIEF

A. Introduction

The City of O'Fallon, City of Fairview Heights and Village of Caseyville collectively intervened in this proceeding. Only O'Fallon and Caseyville are customers of the Company. O'Fallon purchases from the Company its water supply for O'Fallon's distribution system and for resale to Fairview Heights. O'Fallon and Caseyville are within the Company's Interurban District and Southern Division. For purposes of the Company's reply, these three communities collectively will be referred to as "O'Fallon."

O'Fallon presented no witnesses or evidence. Its untimely effort to extend the due date for submittal of its testimony and to delay the case was denied by both the Examiner and the full Commission. Therefore, O'Fallon's assertions stand naked in the record, and must be judged accordingly.

As an intervenor, O'Fallon has the burden of proof to support its allegations. "It has long been held that the burden of proof in rate cases is upon the complainant to show unreasonableness or discrimination." *Champaign County Telephone Co. v. Illinois Commerce Commission*, 37 Ill. 2d 312, 321 (1967). O'Fallon, obviously, failed to do so.

In its introduction, O'Fallon asserts that the obligation of Staff and the Commission is only "to protect the interests of ratepayers." This assertion is **not** correct. The obligation of Staff and the Commission is to consider the interests of both the utility and its customers. "A hearing before the commission is not a partisan hearing with the commission on one side arrayed against the utility on the other." *Fleming v. Illinois Commerce Commission*, 388 Ill. 138, 147 (1944).

B. The Company Is Not Low Risk

O'Fallon makes the absurd assertion that the Company is "low risk" because the Commission "ensures, through its legislative rate powers, that all of Water Co.'s expenses of service are covered and that Water Co. is permitted to obtain a reasonable rate of return on rate base." (O'Fallon initial brief, p. 4).

Clearly, O'Fallon is confused. Apparently, it does not understand that rate making is prospective only, and that earnings shortfalls cannot be retroactively recovered. *Illinois Bell Telephone Co. v. Illinois Commerce Commission*, 203 Ill. App. 3d 424 (2nd Dist. 1992); *City of Chicago v. People of Cook County*, 133 Ill. App. 3d 435 (1st Dist. 1985). It also apparently does not understand that the Commission sets rates to give a utility only an **opportunity** to earn a certain return, and that there is a difference between an **allowed** return versus an **earned** return.

For example, the Company's earned return in the Southern Division/Peoria District for the test year is 7.05%, while the allowed return per the current rate order is 9.05% (Company Exhibit 10.0, p. 7; Order, Docket No. 97–0102/97–0081 Cons.).

The point is that regulation assures the Company only of the **opportunity** to periodically request rate relief in a process that can take up to eleven months and which can, at best, provide only a **prospective** opportunity to earn a specified return.

Water utilities face substantial risks, as Mr. Gloriod's uncontroverted testimony enumerates (Company Exhibit 1.0, pp. 16–24). Some of these risks include:

1. Compliance with the Safe Drinking Water Act and Clean Water Act.
2. Replacement of aged infrastructure.
3. Potential for illness or fatalities from contamination.
4. Competition.

5. Regulatory requirements.

6. Limited sources of supply.

7. Capital intensity.

8. Fixed costs.

9. Conservation.

10. Bypass.

11. Eminent domain.

That these risks exist are not only the opinion of Mr. Gloriod. He presented as Company Exhibits 1.1 and 1.2 articles on infrastructure needs and costs; and as Exhibit 1.3 a statement by Moody's of increased risks to water utilities.

O'Fallon attacks the rate of return process employed by the witnesses for the Company, Staff and IIWC. However, O'Fallon overlooks that while there may be differences and disagreements between the three witnesses, each generally employs methodologies which have been adopted by this Commission for almost ninety years. These methodologies include calculation of DCF, CAPM and other cost of common equity values for proxy groups of companies.

Along this line, the Commission should note that Staff witness McNally found that the Company was most like American States Water Company and Philadelphia Suburban (T. 300). Mr. McNally determined that his DCF cost of common equity values for these two companies essentially were the highest among his water company sample and among the highest for his comparable sample (*See* Staff Exhibit 3.0, Schedule 3.8). Thus, Mr. McNally's analysis indicates that the Company is at the high end of the risk level.

O'Fallon asks the Commission to set a rate of return at the yield "for the appropriate taxable U.S. Government debt instrument." (O'Fallon initial brief, p. 19). Although O'Fallon

does not allege what this rate would be, it can be assumed that it is referring to the 5.81% Treasury Bond rate or 6.40% Treasury Bill rate referenced in Mr. McNally's testimony.

O'Fallon's request is absurd. It is uncontroverted that the Company's cost of debt is 6.97%. O'Fallon's assertion would constitute illegal confiscation *per se*. *Peoples Gas Light Co. v. Slattery*, 373 Ill. 31, 68 (1939): "if [a public utility] company could take a sum equivalent to the value of its property and invest it soundly, so as to insure a rate of return in excess of the return authorized by the commission, this would be proof, or at least evidence, of confiscation * * *."

C. A Cost Of Service Study Would Be Adverse To O'Fallon

O'Fallon makes the curious assertion that the rate increase to be determined in this proceeding should be applied based on a cost of service study rather than across–the–board as proposed by the Company (O'Fallon initial brief, p. 10).

The Company has proposed an across–the–board rate increase to mitigate rate impacts on large volume customers such as O'Fallon (*See* Company initial brief, pp. 24–25). O'Fallon will pay higher rates under Staff's cost of service study than it will pay under an across–the–board increase.

The Commission has approved across–the–board rate increases in the past, as even O'Fallon acknowledges (O'Fallon initial brief, p 12).

Incidentally, O'Fallon incorrectly relies upon the testimony of IIWC witness Gorman (O'Fallon initial brief, p. 11). Mr. Gorman actually **supports** the Company's proposed across–the–board increase for the Southern Division/Peoria District (Gorman Rebuttal testimony, p 5).

In addition, the courts have held that cost of service is not the only criterion for allocation of revenue requirements among classes. *See City of Chicago v. People of Cook County*, 133 Ill. App. 3d 435 (1st Dist. 1985); *Citizens Utilities Co. v. Illinois Commerce Commission*, 50 Ill. 2d 35 (1971).

O'Fallon also asserts that it is a wholesale customer and deserves a lower rate. The Company's present rate structure has been approved by the Commission. O'Fallon presented no evidence to support any change in the rate structure. Rate structure is not an issue in this case.

O'Fallon's higher volume purchases are reflected in the Company's fourth rate block, which provides O'Fallon with a substantial rate discount compared with a typical residential or small commercial customer. That discount takes into account those factors which O'Fallon believes distinguishes it.

Moreover, as O'Fallon acknowledges, the Company has available a large user tariff which has been approved by the Commission. O'Fallon and Caseyville may be better served further discussing with the Company their potential qualification for this tariff (T. 55, 56).

Even though O'Fallon contends that the rate increase be based upon a cost of service study, it recommends in its conclusion that the Company's across–the–board proposal be approved (O'Fallon initial brief, p. 19). Apparently, O'Fallon is uncertain as to its position.

D. Single–Tariff Pricing Is Not An Issue

O'Fallon asserts that single–tariff pricing is an issue in this proceeding. It is wrong. Single–tariff pricing for the Company's Southern Division and Peoria District was approved by the Commission in Docket No. 92–0116. The Commission's order was affirmed by the Illinois Appellate Court in *Monsanto Co., et al. v. Illinois Commerce Commission, et al.,* No. 5-93-0213 (5th Dist. 1994). It was extended in Docket No. 95–0076 and in Docket No. 97–0102/97–0081

Cons. Neither the Company, nor Staff, nor any Intervenor has proposed any change to single–tariff pricing.

The Company has proposed the Alton Source of Supply Charge, which O'Fallon supports (O'Fallon initial brief, p. 17). That charge is premised upon a net investment per customer concept (*See* Company initial brief, pp. 25–26). The charge is proposed so as to more equitably assign costs of the new Alton treatment facility to customers within the Southern Division/Peoria District single–tariff pricing group.

Respectfully submitted,

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